Shining the spotlight on broker 'secret commissions'

By Katie Scott | 13 March 2020

Defined as a 'species of fraud', brokers have to come clean about hidden commission transactions in order to avoid legal repercussions

Last year, specialist firm M2 Recovery reclaimed nearly £2m on behalf of its commercial and residential clients, recovering what it describes as 'secret commissions' from brokers and property managing agents.

Affecting the non-owner occupied property sector, M2 Recovery's managing director and founder Neil Holloway explained that the cusp of the issue surrounds non-transparent commission payments that are used to secure business between managing agents or landlords and brokers.

"In return for placing the business with the broker, the [managing] agent receives a kickback, the cost of which is passed on to the property owner," he said. "These are referred to as commissions, but they are just hidden illegal payments that can, and should, be claimed back."

M2 Recovery believes that UK commercial property owners and occupiers could be paying out as much as £200m a year in secret commissions, with more than 10% of all large commercial property insurance contracts marked up with hidden kickbacks.

In some cases, additional policy costs can even amount to up to 40% of the overall premium, added Holloway.

End customer impacts

These arrangements are to the detriment of the end customer, whether these are commercial or residential occupiers, Holloway said.

He continued: "The premium becomes, to a greater extent, non-competitive and the main sales pitch to secure the business is how much commission you can provide us.

"You've got a unique situation that the landlord and the managing agent are not actually going to pay the premium at the end of the day.

"The premium, under the terms of the lease, is covered from the people that occupy the building.

"The unfortunate part of it all is the end user who pays the premium is the one that is disadvantaged by this whole arrangement."

Peter Bottomley, member of Parliament for Worthing West and chair of the All Party Parliamentary Group on leasehold and commonhold reform, told *Insurance Times* that "there are still examples of cosy back room deals", confirming Holloway's insights.

He added: "What is clearly essential and should be mandatory is there are no secret commissions or overriding payments; that there's a duty of care by freeholders, by the managing agents and by brokers to those who have to pay the premiums to have effective cover at the lowest cost without overriding commissions that lift the payments leaseholders have to make.

"I don't believe that openness is always there."

Fraud

Although firms have a legal duty of care to be transparent with regards to their earnings and commissions, David Greene, senior partner and head of group action litigation at law firm Edwin Coe, explained that secret commissions are, in fact, "a special species of fraud".

He said: "In insurance, the obligation of the freeholder may [be] to insure a building. They employ a broker to effect the insurance and a secret commission may be paid by the insurer to the broker or

some other go-between party. Not only will the payment of [the] commission be secret, [but] the price of it may be added to premiums.

"This practice also often arises in relation to financial products in which a secret commission is passed from the lender to the broker. This creates issues under the Consumer Credit Act, by which the borrower may avoid entirely the liability.

"A fully secret commission is a special species of fraud which means the contract is rescinded as of right and the commission has to be paid back and there is a claim for damages, [for example,] could the insurance have been purchased at a more competitive rate?"

Greene added that the practice of non-transparent commissions is most commonly seen within mortgage lending, such as in last year's *Wood v Commercial First Business.*

In this example, the practice of secret commissions contradicted section 140A of the Consumer Credit Act 1974, which deals with unfair relationships, as the borrower argued she had not been made aware of the commission - this was, therefore, in breach of the brokers' standard terms and caused an unfair relationship under the aforementioned Act.

Explaining the legalities, Holloway added: "It is a matter of the law of agency. A secret profit is any financial benefit obtained by an agent in the course of acting for his principal which he has not disclosed to his principal.

The agent is liable to account to his principal for any such amount that he receives. There does not need to be dishonesty or fraud."

An M2 Recovery spokesperson said the law of agency was covered by Bottomley's All-Party Parliamentary Group on Leasehold and Commonhold Reform - the practice was identified as illegal and, as such, there was no necessity for a change in law.

Greene agreed: "It's not a statute law, but a well-established principle usually arising from contract or fiduciary obligations at common law."

Holloway continued: "The law is very sound. What should happen is the broker should disclose to the landlord that [it is] paying a managing agent a commission.

"If they are transparent and they disclose the commission payment, they are entitled to the commission. It's the fact that they [do not] disclose [this] that causes the problem."

Income implications

But, why are some brokers resorting to these types of commission arrangements, exposing themselves to the evident legal risks that they pose?

Bottomley answered with a simple "money grabbing", however Holloway explained that very often the vast sums of money involved make it financially difficult for firms to revise their commission procedures.

He said: "Brokers can't change the way they trade because they've got too much exposure as far as income is concerned, whether they entered into this arrangement with landlords or managing agents. Most brokers are under pressure for income.

"They can't disentangle because they're making too much money out of it – they can't give the income up because it's just too vast. It's not unusual to find a managing agent who's earning £400,000, £500,000, £600,000 a year out of insurance commissions that [it is] not disclosing.

"It is not unusual to find some brokers who are earning 40%, 45% or even 50% commission under a policy because of the pay aways that they have to provide to get the business."

Holloway added that even if firms do amend their arrangements, what do they do with the leftover 20% or 30% commission pool? Does the money go back to the insurer? Is it used to reduce premiums? These questions add an extra layer of complexity.

Additionally, retrieving these types of sums through legal action can have a huge detrimental impact on smaller brokers. "You don't want to be chasing the £200,000, £300,000 [from a] relatively small insurance broker because [they aren't] going to have the ability to pay you," Holloway explained.

Regulation?

For Bottomley, the ball is firmly in insurers' court to rectify this imbalance, which according to Holloway has been ongoing for a number of years – at least the duration of his 30-year career.

"The insurance companies ought to be knowing what's going on, they should stop it," Bottomley said.

Greene, on the other hand, is speaking with Holloway on potentially launching an opt in collective action – he said this is a "much more efficient way of dealing with a common problem".

The FCA should also have a remit here, added Holloway, especially as many individuals within the sector are unaware of the rules and regulations around commission payments.

"Most brokers can't see it as an area of concern. Some of the big boys, I think, take the view that if we get caught, we can deal with it. But I think the FCA should really step in and regulate or put guidelines down for this type of arrangement where commissions are being paid away," he said.

“Brokers going forward have got to come clean and be transparent with regards to their earnings arrangement.”

Subscribers read more

Proposed premium finance commission rules – what does it mean for brokers?